

# *Oversight Report*



EVALUATION OF CONTRACTOR ACCOUNTING  
AND ESTIMATING FOR POSTRETIREMENT  
BENEFIT COSTS AND RELATED DOD OVERSIGHT

Report Number D-2000-6-007

August 4, 2000

Office of the Inspector General  
Department of Defense

### **Additional Copies**

To obtain additional copies of this evaluation report, visit the Inspector General, DoD Home Page at: [www.dodig.osd.mil](http://www.dodig.osd.mil) or contact the Secondary Reports Distribution Unit of the Audit Followup and Technical Support Directorate at (703) 604-8937 (DSN 664-8937) or fax (703) 604-8932.

### **Suggestions for Future Evaluations**

To suggest ideas for or to request evaluations, contact the Audit Followup and Technical Support Directorate at (703) 604-8940 (DSN 664-8940) or FAX (703) 604-8932. Ideas and requests can also be mailed to:

OAIG-AUD (ATTN: AFTS Evaluation Suggestions)  
Inspector General, Department of Defense  
400 Army Navy Drive (Room 801)  
Arlington, VA 22202-2885

### **Defense Hotline**

To report fraud, waste, or abuse, contact the Defense Hotline by calling (800) 424-9098; by sending an electronic message to [Hotline@dodig.osd.mil](mailto:Hotline@dodig.osd.mil); or by writing to the Defense Hotline, The Pentagon, Washington, D.C. 20301-1900. The identity of each writer and caller is fully protected.

### **Acronyms**

ACO	Administrative Contracting Officer
CAS	Cost Accounting Standards
CIPR	Contractor Insurance Pension Review
DCAA	Defense Contract Audit Agency
DCMA	Defense Contract Management Agency
DFARS	Defense Federal Acquisition Regulation Supplement
DLA	Defense Logistics Agency
FAS	Financial Accounting Standards
FAR	Federal Acquisition Regulation
GAAP	Generally Accepted Accounting Principles
I/P	Insurance/Pension
PRB	Postretirement Benefit



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202

August 4, 2000

MEMORANDUM FOR DIRECTOR, DEFENSE PROCUREMENT  
DIRECTOR, DEFENSE CONTRACT AUDIT AGENCY  
DIRECTOR, DEFENSE CONTRACT MANAGEMENT  
AGENCY

SUBJECT: Evaluation Report on Contractor Accounting and Estimating for  
Postretirement Benefit Costs and Related DoD Oversight  
(Report No. D-2000-6-007)

We are providing this report for review and use. We considered management comments on a draft of this report in preparing the final report.

Management comments were generally responsive and conformed with the requirements of DoD Directive 7650.3. No further comments are requested.

We appreciate the courtesies extended to the evaluation staff. Questions on the evaluation should be directed to Ms. Patricia A. Brannin at (703) 604-8802 (DSN 664-8802) (pbrannin@dodig.osd.mil) or Ms. Madelaine E. Fusfield at (703) 604-8739 (DSN 664-8739) (mfusfield@dodig.osd.mil). See Appendix D for the report distribution. The evaluation team members are listed inside the back cover.

A handwritten signature in black ink, reading "Robert J. Lieberman", is positioned above the printed name.

Robert J. Lieberman  
Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

Report No. D-2000-6-007

August 4, 2000

(Project No. D1998OA-0034, Formerly Project No. 8OC-9011)

### Evaluation of Contractor Accounting and Estimating for Postretirement Benefit Costs and Related DoD Oversight

#### Executive Summary

**Introduction.** During the review, the Defense Logistics Agency was the DoD executive agency responsible, through its Defense Contract Management Command, for conducting Contractor Insurance/Pension Reviews with the assistance of the Defense Contract Audit Agency. Effective March 27, 2000, the Defense Contract Management Agency was established, and it is now the responsible agency for conducting Contractor Insurance/Pension Reviews. The purpose of the reviews is to evaluate contractor insurance programs, pension plans, and other employee benefit plans. Contractor policies, procedures, and practices are reviewed to determine whether insurance and employee benefit costs charged to Government contracts comply with the Federal Acquisition Regulations and the Cost Accounting Standards. The Defense Federal Acquisition Regulations Supplement subpart 242.73, Contractor Insurance/Pension Review, provides that reviews should be performed on contractors that have actual or anticipated qualifying annual sales to the Government of \$40 million or more on negotiated prime contracts or subcontracts.

Health care benefits constitute about 80 percent and life insurance about 19 percent of all expenditures for postretirement benefits other than pensions. The General Accounting Office has reported that Medicare and health programs for retirees are high-risk areas.

**Objectives.** The overall objective was to evaluate the adequacy of DoD oversight of postretirement benefit costs other than pensions. We also determined how contractors estimate and account for those costs. We evaluated 25 Contractor Insurance/Pension Reviews performed by the Defense Contract Management Agency on 23 contractors and 22 audits performed by the Defense Contract Audit Agency on 4 of the same contractors.

**Evaluation Results.** DoD needed to ensure that group insurance costs charged to Government contracts are reasonable and tested according to regulatory guidance and that information on service organizations is obtained and evaluated. Also, there was a need for additional rules and regulations covering segment accounting for postretirement benefits.

- The Defense Contract Management Agency needed better criteria for determining the reasonableness of postretirement benefit costs. Also, DoD reviewers did not always test whether costs were allowable according to regulatory guidance and did not obtain information on service organizations' controls. Also, the Agency had not developed a comprehensive joint Group Insurance Review Program. The deficiencies in review coverage could result in overpayments to DoD contractors for group insurance costs that are not

reasonable, allowable, or allocable. For example, at 2 of the 23 contractors evaluated, we estimated the impact from the deficiencies to be about \$4.7 million (finding A).

- Contractors requested adjustments of previously unfunded postretirement benefit liabilities after segments were closed because of discontinued operations or the sale of a business segment. The contractors turned to contract appeal boards, and in some instances the courts, to settle claims representing substantial accrued unfunded liabilities that the Government had no contractual obligation to settle. Although the Federal Acquisition Regulations covered the allowability issues that arose, additional cost accounting standards guidance was needed to address the measurement of costs and the computation of amounts to be adjusted, if any, after a segment closed (finding B).

**Summary of Recommendations.** We recommend that the Director, Defense Contract Management Agency, issue guidance for using actuarial surveys and coordinate with the Director, Defense Contract Audit Agency, to complete the joint review guide on group insurance costs, including postretirement benefit costs.

We also recommend that the Director, Defense Procurement, work with the Cost Accounting Standards Board to develop additional rules and regulations covering segment accounting for postretirement costs.

**Management Comments.** The Defense Contract Management Agency concurred with the two recommendations but disagreed that managers had provided inadequate oversight or guidance for determining reasonableness of postretirement benefit costs. Refer to finding A for a complete discussion of management comments. However, they agreed to issue a policy change to reinforce the use of actuarial surveys to evaluate contractors' group insurance programs. The Defense Contract Management Agency will also work with the Defense Contract Audit Agency to complete a joint review guide for group insurance costs, including postretirement benefit costs. The policy change notice and the review guide will be issued by September 30, 2000. The Acting Director, Defense Procurement, concurred with the recommendation.

Although not required to respond, the Defense Contract Audit Agency commented that they will work with the Defense Contract Management Agency to complete the joint review program. They will also question increased costs caused by delayed funding of postretirement benefit costs in fiscal years for which overhead rates have not been settled.

**Evaluation Response.** The management comments are generally responsive, although we stand by the finding on oversight and guidance. We will track the implementation of the recommendations, including the issuance of guidance for using actuarial surveys that address when costs should be questioned, through our followup process.

# Table of Contents

---

<b>Executive Summary</b>	i
<b>Introduction</b>	
Background	1
Objectives	2
<b>Findings</b>	
A. DoD Oversight of Postretirement Benefit Costs	3
B. Postretirement Benefit Accounting Problems After Segments Closings	11
<b>Appendixes</b>	
A. Evaluation Process	
Scope	16
Methodology	17
Prior Coverage	18
B. Defense Contract Management Agency Contract Insurance Pension Reviews (CIPRs) Evaluated	19
C. Defense Contract Audit Agency Audits Evaluated	20
D. Report Distribution	21
<b>Management Comments</b>	
Director, Defense Procurement	23
Director, Defense Contract Audit Agency	25
Director, Defense Contract Management Agency	27

---

## Background

**Contractor Insurance/Pension Reviews.** During our review, the Defense Logistics Agency (DLA) was the DoD executive agency responsible, through its Defense Contract Management Command, for conducting Contractor Insurance/Pension Reviews (CIPRs). Effective March 27, 2000, the Defense Contract Management Agency (DCMA) was established, and it is now the responsible agency for conducting CIPRs. The purpose of CIPRs is to evaluate contractor insurance programs, pension plans, deferred compensation, and other employee benefit plans. The DCMA employs Insurance/Pension (I/P) specialists to review contractor policies, procedures, and practices to determine whether insurance and employee benefit costs charged to Government contracts comply with the Federal Acquisition Regulations (FAR) and the Cost Accounting Standards (CAS). The I/P specialists primarily review the actuarial methods of measuring insurance and employee benefit costs and the reasonableness of actuarial assumptions and benefit levels. A designated Defense Contract Audit Agency (DCAA) auditor participates as a member of the CIPR team, providing advice and information in a separate report to the CIPR team captain based on an analysis of the contractor's books, accounting records, and procedures. Although specific team responsibilities may vary, the auditor is generally responsible for verifying insurance/pension costs to the contractor's books and records and for evaluating the allocability and reasonableness of the claimed cost.

The Defense Federal Acquisition Regulations Supplement (DFARS) subpart 242.73, Contractor Insurance/Pension Review provides that CIPRs should be performed on contractors that have actual or anticipated qualifying annual sales to the Government of \$40 million or more on negotiated prime contracts or subcontracts. Qualifying annual sales are contracts for which certified cost or pricing data were required or cost-reimbursement type contracts. Sales include prime contracts, subcontracts, and modifications.

On July 29, 1998, the Director, Defense Procurement, issued guidance to the Directors of DoD agencies advising them that the DFARS guidance was amended to eliminate the requirement for conducting a CIPR every 2 years. Instead, the Administrative Contracting Officer (ACO), with advice from the I/P specialist and DCAA auditors, should determine when a CIPR is needed based on a risk assessment of past experience and current vulnerability. The revised rule also affirmed DCAA contract audit responsibilities, FAR subpart 30.2, "CAS Program Requirements," and FAR subpart 30.6, "CAS Administration."

**Postretirement Benefits Other Than Pensions.** About 80 percent of postretirement benefits (PRBs) other than pensions that employers provide to retirees are health care insurance benefits. Life insurance benefits represent 19 percent and the remaining percentage is miscellaneous benefits. Employers provide health care benefits through insurance plans or self-insurance programs and account for the costs on the cash or accrual method of accounting.

**Financial Accounting Standards.** Statement of Financial Accounting Standards (FAS) 106, "Employers Accounting for Postretirement Benefits Other than Pensions," became effective for fiscal years beginning after December 15, 1992. FAS 106 significantly changed the prevalent cash method of accounting for PRBs

---

by requiring that PRB costs be accrued during the years that the employee renders the necessary service. The statement requires the contractor, when adopting FAS 106, to measure and report a transition obligation equal to the amount of the initial accumulated, unfunded, and unrecognized PRB obligation. The FAR subpart 31.205-6(o), "Postretirement benefits other than pensions (PRB)," allows contractors to use cash, accrual, or terminal funding. If the accrual accounting method is used, FAR requires compliance with generally accepted accounting principles (GAAP) for PRB costs.

**Cost Accounting Standards Board Staff Discussion Paper.** On September 20, 1996, the CAS Board issued a discussion paper for public comment on "Cost Accounting Standard Relating to the Treatment of Costs of Post-Retirement Benefit Plans Other Than Pension Plans Sponsored by Government Contractors." DoD issued a consolidated response to the discussion paper on December 17, 1996. The response indicated that GAAP does not provide adequate guidance for the measurement and period assignment of PRB costs because it is insufficient in the areas of funding and the treatment of gains and losses, initial unfunded liabilities, segment closings, plan terminations, benefit curtailments, and the level principal payment amortization method. The response stated that amending existing standards to provide this guidance is preferable, provided the amendments can be accomplished without unreasonably complicating existing standards.

## Objectives

Our objective was to evaluate the adequacy of DoD oversight of postretirement benefit costs other than pensions and to determine how contractors estimate and account for those costs. See Appendix A for prior coverage related to the audit objectives.



---

## A. DoD Oversight of Postretirement Benefit Costs

DoD oversight of contractor postretirement benefits (PRBs) other than pensions needed improvement in some areas. The lack of adequate oversight occurred because DCMA managers did not provide adequate guidance and appropriate industry norms for determining reasonableness. In addition, reviewers did not consistently test and document whether costs were allowable as required by regulatory guidance, and the reviewers did not address contractor use of service organizations. Also, DCMA managers did not formalize individual review steps for conducting group insurance reviews. The deficiencies in review coverage could result in overpayments to DoD contractors for group insurance costs that are not allowable, allocable, or reasonable. For example, for 2 of the 23 contractors reviewed, we estimated that the impact could have been \$4.7 million.

### Reasonableness of PRB Costs

**Guidance for Determining Reasonableness.** FAR subpart 31.201-3, “Determining Reasonableness,” stipulates that a cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of competitive business. The burden of proof is on the contractor to establish that costs are reasonable.

The March 1998 DLA Directive 5000, “ONEBOOK,” chapter 4.4.2, contains limited guidance on CIPRs. The July 1998 DCAA Contract Audit Manual, 6-413.4d., “Determination of Reasonableness of Compensation Costs” gives guidance on determining reasonableness. Specifically, “Individual elements of compensation (such as wages and salaries, bonuses, fringe benefits and deferred compensation) may each be subject to the FAR tests and be considered unreasonable if they exceed the market survey weighted average data by 10 percent without justification.” Also, auditors should consider the results of CIPRs when determining the scope of the benefits program review and the overall reasonableness of contractor compensation packages.

**DoD Oversight of the Reasonableness of PRBs.** The CIPR team usually analyzed PRBs as part of the review of group insurance costs. The analysis of the reasonableness of group insurance costs was limited and thus may have yielded distorted results. To evaluate reasonableness, I/P specialists computed the actual average annual group insurance costs per active employees and the average total group insurance costs as a percentage of payroll and then typically compared the averages to commercial company norms published in the Chamber of Commerce Survey, “Employee Benefits as Dollars Per Year Per Employee, by Type of Benefit and Industry Group, 1994.” Fourteen of the CIPRs (Appendix B) did not question costs as unreasonable or adequately explain why costs exceeded industry norms, although, in one case, the average costs per employee exceeded industry norms by more than 80 percent. We were unable to determine the potential cost impact of deviations from the norms due to the limited CIPR analyses of cost

---

reasonableness. However, a majority of Government contractors were going through major downsizing and had a higher than average ratio of retirees to active employees. According to technical specialists, the Chamber of Commerce Survey they used did not provide suitable norms for PRB costs of major Defense contractors because it did not include sufficient information to facilitate an analysis of the average costs per beneficiary. Also, the averages encompassed data pertaining to small businesses not representative of major Defense contractors. In some instances, the Chicago CIPR Team used the "Mercer/Foster Higgins National Survey of Employer-Sponsored Health Plans" and was able to explain deviations from industry norms.

**Need for DCMA Guidance.** The use of inappropriate industry norms and the lack of adequate guidance for evaluating the reasonableness of group insurance costs resulted in limited analyses and may have yielded distorted results. Subsequent to our fieldwork, the DCMA Headquarters management informed us that it had provided to field offices the National Health Care Trend Survey, Buck Consultants, Inc., an appropriate industry norm for evaluating group insurance costs. However, DLA had not issued adequate guidance for using the new survey to help Insurance/Pension specialists in evaluating the reasonableness of group insurance costs.

## Testing of CAS and FAR Requirements

**CAS Requirements.** CAS 416, "Accounting for insurance costs," Preamble A, paragraph 10, explains that the inherent nature of health benefits for retirees determines whether the costs should be accounted for as pension costs per CAS 412, "Composition and Measurement of Pension Costs," or as insurance costs per CAS 416. According to the preamble, if PRBs are part of the group insurance plan, CAS 416 governs. If PRBs are an integral part of the pension plan, then CAS 412 and 413, "Adjustment and Allocation of Pension Costs," govern the accounting and allocation methods. CAS 416-40(b) requires that insurance costs be allocated to contracts based on the beneficial and causal relationship between the insurance costs and the benefiting cost objectives. Preamble A, paragraph 13, also explains that CAS 403, "Allocation of Home Office Expenses," provides the criteria for allocating insurance costs from a home office to segments. CAS 403 requires that insurance costs be allocated directly to the benefiting segments. When a segment does not benefit from the insurance or cause the expense, CAS 403 provides for a special allocation procedure.

The purpose of CAS compliance testing is to ensure that contractors appropriately measure PRB costs, assign the costs to the accounting period, and provide for an equitable allocation of costs to contracts.

**DCMA CAS Compliance Testing.** DCMA did not document CAS compliance testing for CAS 403 or CAS 416 in the 25 CIPR files evaluated. DFARS subpart 242.73, "Contractor Insurance/Pension Reviews," was revised in June 1998 to clarify that DCAA is now primarily responsible for performing CAS compliance testing and reporting CAS noncompliances to the contracting officer as part of the joint CIPR team effort. All of the reports reviewed were issued prior to June 1998.

---

**DCAA CAS Compliance Testing.** DCAA had tested contractor compliance with applicable CAS provisions as part of the comprehensive testing of each individual standard in special CAS audits. The results of the special CAS audits were adequately considered in all 22 DCAA audits reviewed.

**Differing Interpretations of CAS Applicability for Allocating PRB Costs.**

Auditors questioned PRB cost allocations at three major contractors. However, DCMA contracting officers differed with DCAA audit interpretations of CAS 403 and CAS 416 for allocating PRB costs to segments. Therefore, questioned costs were not always sustained.

An example that illustrates the differing interpretations for allocating and accounting for PRB costs was the settlement agreement reached at one of the major contractors. The DCAA reported that the practices for allocating PRB costs were in noncompliance with CAS 403 and CAS 416 because the proposed indirect allocations did not meet the CAS requirements that costs be allocated to benefiting cost objectives. The ACO entered a settlement agreement with the contractor that did not resolve the noncompliance issue but allowed for a reimbursement to the Government of a \$14.5 million impact of cost transfers from commercial to Government contracts. The agreement did not state that the subject accounting practices were acceptable. Rather, "acceptance by both Parties of any adjustment . . . is for the sole purposes of resolving the aforementioned Audit Report and associated disagreements regarding allocating and accounting for PRB costs . . . and do [sic] not necessarily indicate agreement or concurrence by the Government that these practices constitute an appropriate or compliant method for allocating and accounting for PRB costs." The ACO concluded that the costs could be allocated as residual expenses, in part justifying the decision by stating that the 1996 CAS Board Staff Discussion Paper indicated that CAS did not cover PRBs. Though CAS coverage is necessary to prescribe the measurement and adjustment of accrued PRB costs, CAS 403 and 416 adequately cover the allocation of PRBs as home office and insurance expenses, respectively.

As another example, in a December 30, 1997, report, DCAA auditors cited the contractor for noncompliances with CAS 403 and 416. The auditors reported that the allocation base was not related to the method used to compute the costs for allocation. In a second related report, April 28, 1998, DCAA reported that CAS 403 and 416 require that the costs be directly allocated, since each group had its own medical plan.

The Defense Corporate Executive disagreed with the auditors and indicated that pooling of costs was a better technique based on the impact of the recent acquisition.

**FAR Allowability Requirements.** FAR subpart 31.205-6(o), "Postretirement benefits other than pensions," allows contractors to choose between cash, accrual, or terminal funding methods to account for PRBs costs. Under the cash method, benefits are recognized as costs when actually provided and paid for.

FAR 31.205-6(o)(2)(iii) specifies that to be allowable, accrued PRB costs must be measured and assigned according to Generally Accepted Accounting Principles (GAAP). FAS Board Statement 106, "Employers' Accounting for Postretirement Benefits Other than Pensions," (FAS 106), as incorporated into the FAR provides the criteria for measuring allowable PRB costs. When a contractor first adopts the FAS 106 accrual method, it must compute a transition obligation to account for

---

previously unrecorded liabilities related to employee benefits earned for prior service. The transition obligation must be amortized on a straight-line basis over the average remaining service period of active plan participants or 20 years. If almost all of the plan participants are inactive, the employers must use the average life expectancy of plan participants. For a CAS-covered contractor, CAS 416 imposes a 15-year amortization.

If a contractor accrues and funds PRB costs, contributions to the fund or trust must be made quarterly, and DoD reviews must test compliance with the cost principles and contract clauses. FAR 31.205-6(o)(3) requires costs to be funded or otherwise liquidated by the date set for filing the tax return. Any unliquidated costs are not allowable in subsequent years. FAR 31.205-6(o)(4) disallows increased costs caused by delay in funding beyond 30 days after each quarter of the year. FAR subpart 52.232-16, "Progress Payments," also requires a contractor to exclude unfunded PRB and pension amounts from progress billings.

**DCMA FAR Compliance Testing.** Eleven of the 25 CIPR files reviewed did not adequately test contractor compliance with the FAR allowability requirements (Appendix B).

- Two CIPRs at one location did not mention the contractor's practice of only funding at the end of the year. CIPR files did not contain documentation to justify acceptance of increased costs caused by not funding quarterly.
- Eight additional CIPRs did not adequately address accrued PRB costs. Therefore, contractor compliance with FAR and FAS 106 could not be determined.
- Lastly, one CIPR did not test contractor compliance with FAS 106 guidelines for amortizing the PRB transition obligation. The contractor used an amortization period of 10 years, which did not represent the average remaining service period. We estimated the increased cost caused by the abbreviated amortization period to be about \$1.18 million in 1996. The practice existed at least since 1995 and was discontinued in 1997. We projected that over a 3-year period the increased costs may be as high as \$3.5 million.

**DCAA FAR Compliance Testing.** Eight audits at three contractor locations showed the following deficiencies:

- Four incurred cost audits at two different contractors did not adequately document an analysis of the contractor's use of an actuarial cost method not acceptable per FAS 106.
- Two incurred cost audits at a third location did not identify potential increased costs due to contractor delayed funding of PRB costs. We estimated the lost interest caused by delayed funding to be about \$395,000 in 1996. The practice of delayed funding had existed for several years and was not discontinued until 1998. We projected that over a 3-year period the lost interest may have been \$1.2 million.

- 
- Two forward pricing audit reports issued by one corporate audit office did not disseminate information to segments on the need to exclude any unfunded PRB expenses from progress billings.

## **Contractor Administration of a Self-Insurance Program**

**Use of Service Organizations.** DoD contractors may elect to provide coverage for certain risks from their own resources under a program of self-insurance. A contractor may administer its self-insurance program either by employing qualified personnel or by contracting with one or more service organizations to provide the necessary services or both.

Government Auditing Standards on reporting for financial audits incorporate Statement on Auditing Standards No. 70, "Reports on the Processing of Transactions by Service Organizations." Statement on Auditing Standards No. 70 provides guidance on the factors independent auditors should consider when auditing the financial statements of an entity that uses a service organization to process certain transactions. Statement on Auditing Standards No. 70 notes that the relationship of the controls of the service organization to those of the user organization depends primarily on the nature of the services provided by the service organization. For example, when the service organization executes the organization's transactions and maintains the related accountability, there is a lower degree of interaction, and it may not be practicable for the user organization to implement effective controls for those transactions. Therefore, evidence should be derived from one or more of the following: tests of the user organization's controls over the activities of the service organization; a service auditor's report on controls placed in operations and tests of operating effectiveness; or a report on the application of agreed-upon procedures that describes the relevant tests of controls or appropriate tests of controls performed by the user auditor at the service organization.

**DCAA Guidance for Audits of Insurance Costs.** The Contract Audit Manual, chapter 7-506, "Self-Insurance Cost," provides guidance for reviewing contractor self-insurance plans and requires that the auditor evaluate the effectiveness of contractor claims procedures for self-insurance. Preliminary audit steps in the DCAA "Audit Program for Insurance Costs" require obtaining management and insurance carrier reports to identify potential problems. However, when participating in a CIPR, the auditor usually performs only tasks requested by the CIPR team.

**Supporting Data on Service Organizations.** Although there was minimal interaction between Lockheed Martin, Northrop Grumman, Raytheon, and TRW and their service organizations, information on the service organizations was not obtained as part of the CIPRs or DCAA audits. Information on the service organizations was probably not obtained because there is no joint review program for conducting CIPRs where responsibilities are defined, and DCAA relies on the CIPR work in determining the scope of its subsequent audits. Not obtaining information on the internal controls of a service organization places the Government at risk of not being aware of illegal acts or fraud attributable to the service organization's management or employees.

---

## Management Actions on Joint Review Programs

In Inspector General, DoD, Report No. PO 97-013, "DoD Oversight of Defense Contractor Insurance and Pension Plans," March 28, 1997, we again identified that billions of dollars of contractor pension fund assets, accumulated from charges to Government contracts, continued to be exposed to undue risk because of inadequate and untimely reviews of contractor pensions plans. In response to the report recommendations, the Director, Defense Procurement, and the Director, DLA, stated that a joint review guide would be put in place by April 30, 1997. The DLA stated that the review program would recognize DCAA responsibility for reviewing allocation and assignment of insurance and pension costs. The review program would also recognize DCMA responsibility for reviewing the actuarial techniques of measuring insurance and pension costs and reasonableness of actuarial assumptions and benefit levels.

On February 20, 1998, DLA issued two review guides covering pension costs: the Joint Initial and Incurred Cost CIPRs Program and the Joint Segment Closing, Curtailment of Benefits and Plan Termination CIPR Program. Although the DLA in late 1998 developed a draft joint review guide for group insurance, it has not been issued. Additional work still needs to be done on the joint program for insurance, and the program needs to be coordinated with DCAA.

**Management Control Assessment of CIPRs.** We discussed with DLA management the management control program for CIPRs. DCMA officials inappropriately assessed the management control risk for CIPR coverage as low. We were advised that management planned to evaluate 1 of 10 CIPRs as part of the management control plan. However, none were evaluated.

**Summary.** In this review, the CIPRs uncovered a lack of proper review coverage, and many of the same conditions identified in our 1993 and 1997 reports continue to exist, including inadequate testing of FAR and CAS requirements. In addition, our March 28, 1997, report on DoD Oversight of Defense Contractor Insurance and Pension Plans, see Appendix A, identified conditions in the CIPR review programs that reflected material management control weaknesses.

The DFARS 242.73 assigns primary CIPR responsibilities to the I/P specialist who serves as team leader during CIPRs. DLA is the executive agency for those reviews. Mutual agreement must be reached between DLA and DCAA on the scope of review required. A joint review guide is the best means of ensuring adequate review coverage.

In September 1999, DCMA Headquarters reduced the number of I/P specialist positions by 50 percent leaving only 15 specialists to perform CIPR review work. Also, future CIPRs will only be performed based on DCMA assessed risk at a particular contractor location. Therefore, the need for a joint review program for group insurance or other mechanism that clearly assigns review responsibilities is critical to ensure proper review coverage and to minimize risk to the Government.

---

## Management Comments on Findings and Evaluation Response

**DCMA Comments on Findings.** Management nonconcurred with our finding that DCMA managers did not provide adequate guidance and appropriate industry norms for determining reasonableness or that reviewers did not consistently test and document whether costs were allowable as required by regulatory guidance. According to DCMA, the CIPR teams methodically use the CAS 416 and FAR 31.205-6(o) regulations as their guide in reviewing the contractors' PRB programs. Also, the CIPR teams use employee benefit surveys of large corporations such as those prepared by Blue Cross/Blue Shield and Buck Consultants as a baseline for reasonableness.

**Evaluation Response.** The report states that 11 of 25 CIPR files did not show evidence of adequate compliance testing. The report also explains that DCMA only provided the Buck Consultants, Inc., survey to field offices after we had completed our field reviews. The survey was not available to the CIPR teams during our evaluation. None of the Insurance/Pension Specialists interviewed mentioned the Blue Cross/Blue Shield as a satisfactory source of data to determine reasonableness of PRB costs.

## Recommendations, Management Comments, and Evaluation Response

**A.1. We recommend that the Director, Defense Contract Management Agency, issue guidance for using the actuarial survey to evaluate group insurance that addresses when costs should be questioned as unreasonable.**

**DCMA Comment.** Concur. Although the CIPR teams are already doing so, DCMA will reinforce the use of actuarial surveys to evaluate contractors' group insurance programs by issuing a policy change notice. The estimated completion date is September 30, 2000.

**Evaluation Response.** The proposed action is generally responsive to the recommendation. As recommended, the policy change notice should include specific guidance addressing when costs should be questioned as unreasonable. We will work with DCMA and DCAA as the policy change notice is formulated.

**A.2. We recommend that the Director, Defense Contract Management Agency, coordinate with the Director, Defense Contract Audit Agency to complete a joint review guide for group insurance costs, including postretirement benefit costs, within 60 days from the date of this report. Review steps should be included to test compliance with regulations, including the allocation of group insurance costs and to obtain information on service organizations.**

---

**DCMA Comment.** Concur. In coordination with DCAA, DCMA will formalize a guide for reviewing contractors' group insurance programs, including post retirement benefit costs, with emphasis on ensuring adequate supporting documentation is readily available. The estimated completion date is September 30, 2000.



---

## **B. Postretirement Benefit Accounting Problems After Segment Closings**

Contractors requested adjustments of previously unfunded PRB liabilities after segments were closed because of discontinued operations or the sale of a business segment. We reviewed 12 contractor requests for adjustments of which 6 resulted from the discontinued operations of Government Owned Contractor Operated facilities and 6 resulted from segment sales. Although existing FAR provisions covered the allowability issues that arose, CAS guidance was needed to address the measurement of PRB costs and the computation of amounts to be adjusted, if any, after a segment closed. When issues arose that were inadequately covered by existing guidelines, contractors, in some cases, turned to contract appeal boards and the courts to settle claims representing substantial accrued unfunded liabilities that the Government had no contractual obligation to settle.

### **Regulations Pertaining to PRB Liabilities**

Most contractors must comply with FAS 106 accrual accounting requirements for financial reporting purposes, but FAR allows the contractor to use the cash, terminal funding, or accrual methods to calculate costs on Government contracts. Although funding of accrued liabilities is not a FAS 106 or financial reporting requirement, a contractor using the accrual method for Government contract costing must fund or otherwise liquidate accrued liabilities. Funding is not required if the cash method is used.

**Federal Acquisition Regulation Guidance.** FAR 31.205-6(o)(5) limits the allowability of costs attributable to past service of an employee, the “transition obligation,” which is recognized at the time FAS 106 is adopted. The amount a contractor can assign to a fiscal year for amortization of the transition obligation must not exceed the amount calculated using the delayed recognition methodology described in FAS 106. If allowable PRB costs cannot be absorbed through remaining business operations, contractors that have surplus pension fund assets may resolve the issue by entering into an advance agreement with the Government to transfer pension assets to cover the PRB liabilities.

FAR subpart 31.205-6(j)(3), “Defined Benefit Pension Plans,” provides criteria for the use of pension fund assets to offset PRB liabilities. However, FAR 31.205-6(j)(3)(v) disallows increased pension costs resulting from the withdrawal of assets from a pension fund and transfer to another employee benefit plan fund except to the extent authorized by an advance agreement. The advance agreement shall: (A) State the amount of the Government’s equitable share in the gross amount withdrawn; and (B) Provide that the Government receive a credit equal to the amount of the Government’s equitable share of the gross withdrawal.

**Cost Accounting Standards.** According to CAS 416-50(a)(v), if a CAS covered contractor establishes a terminal-funded plan for retired persons, or converts from a pay-as-you-go plan to a terminal-funded plan, the actuarial present value of benefits applicable to employees already retired should be amortized over a

---

period of 15 years. In Preamble (9) to CAS 416, the Board explained that it had rejected a proposal that the 15-year period be renegotiable on a case-by-case basis depending on circumstances. The Board explained that it did not want to reduce uniformity or create an incentive to make changes at times when one of the parties could be expected to benefit.

CAS 413 defines “segment closing” as the event that occurs when a segment is sold or ownership otherwise transferred; operations have discontinued; or the segment discontinues. The standard prescribes specific procedures for adjusting pension plan assets and liabilities after a segment is closed. No comparable coverage exists for PRBs under CAS 416. However, a PRB plan that is an integral part of a pension plan should be evaluated under CAS 413 criteria.

## **Contractor Requests for Adjustments of PRB Liabilities**

We reviewed 12 contractor requests for adjustments of unfunded PRB liabilities totaling approximately \$1.13 billion, associated with sold segments. At the time fieldwork was completed, DCAA had audited \$571.2 million, about 51 percent of the total, and questioned about \$453 million, or 79 percent of the \$571.2 million based on current regulations. One contractor withdrew its \$180 million claim. The Defense Corporate Executives sustained \$60 million of the remaining questioned costs.

DCAA appropriately concluded that current regulations do not allow contractors to immediately claim future PRB costs at the time that a segment is sold or operations cease. DCAA typically questioned whether the Government should compensate contractors for new liabilities calculated when a contractor changed from the cash to the accrual method of accounting after the sale of a segment.

The 12 requests for adjustment when segments were sold or operations were discontinued generally involved 3 situations as discussed below.

**Government Owned Contractor Operated Facilities.** Six contractors at Government Owned Contractor Operated facilities submitted requests for one-time adjustments of life-long PRB benefits totaling about \$360 million when operations were discontinued (plants closed or contracts ended). Most of the contractors accounted for PRB costs on a cash basis and, when operations were discontinued, they found themselves with large unfunded PRB liabilities and no remaining contracts to charge future PRB costs against. The status of the six cases were as follows:

- The Army Contract Adjustment Board granted extraordinary contractual relief under Public Law 85-804 to settle claims submitted by Uniroyal Joliet, Uniroyal Newport, and Remington Arms Army Ammunition Plants.
- The Department of Justice settled the combined Thiokol Texas and Louisiana Army Ammunition Plants issues after Thiokol filed a complaint with the U.S. Court of Federal Claims.

- 
- Another contractor also sought extraordinary contractual relief under Public Law 85-804 after a contracting officer rejected its \$4.2 million adjustment request. The Army denied the request, which is currently a claim before the Armed Services Board of Contract Appeals.
  - Lastly, the parent company of another Army Ammunition Plant submitted a request for reimbursement of \$165 million. An Army decision is pending.

**Contractor Use of Pension Fund Assets to Adjust PRB Liabilities.** After segments were sold or closed, 3 of the 12 contractors added the unfunded PRB liabilities to the pension fund liabilities before calculating the adjustment of previously determined pension costs, CAS 413-5(c)(12), "Segment Closing." By adding PRB liabilities to pension liabilities, the contractors were able to show a deficit instead of a surplus in the pension plan. Therefore, the segment closing adjustment would require the Government to reimburse the contractor. However, to apply the CAS 413 segment closing provision to PRB costs, the contractor would have to demonstrate that PRBs were an integral part of the pension plan.

One of the three sold its federal work to another company and, as part of the sales agreement, transferred pension assets to the other company. The sale resulted in PRB curtailment losses that the selling company claimed were part of the pension plan. The DCAA concluded that the PRBs were not an integral part of the pension plan and that the costs resulting from the sale were not previously determined pension costs requiring adjustment under CAS 413. The selling company withdrew its claim.

The second company sold its defense work organization and retained the pension plan surplus attributable to the defense work organization. The selling company wanted to use the retained pension surplus to offset the net actuarial PRB liability. DCAA concluded that the proposal was not equitable to the Government and that it was inappropriate for the contractor to use the accrued pension assets to offset PRB costs accounted for on a cash basis. DCAA determined that the retained pension surplus should be available to the Government with interest and recommended that the contractor reimburse the Government. The case is unresolved.

The third company added PRB liabilities to the accrued pension liabilities resulting in combined liabilities that greatly exceeded the available pension fund assets. A contracting officer's final decision required the company to adjust the previously determined pension costs according to CAS 413-50 (c) (12) and refund the excess, including interest, to the Government. The case is pending a court decision.

A different contractor sold its vehicle systems business. After the sale, the company entered into an advance agreement with the Government that allowed for the transfer of excess pension assets to pay for retiree medical benefits. The company submitted calculations that overstated the PRB liability and reduced the remaining pension asset surplus. Agreement has been reached on the PRB issue; however, a dispute remains in regard to the amount of surplus pension fund assets that were retained. The Department of Justice is addressing the contractor's claim that the Government overstated the amount of pension fund assets available.

---

**Allocation of Retained PRB Liabilities to Remaining Operations to Settle Claims.** Two contractors submitted annual claims for PRB costs associated with sold segments for which the contractors retained retiree benefit liabilities. The annual claims raised allocation issues under CAS 403 and FAR 31.201-4, "Determining allocability," that were appropriately addressed by the auditors. The claims were settled.

Another two contractors sold most of their Government operations but did not submit claims. Instead, the contractors continued to follow their cash basis accounting methods and allocated the unfunded PRB costs to remaining commercial and Government contracts.

## Summary

Continuing contractor requests for adjustments for unfunded liabilities illustrate the need for additional guidance on the treatment of PRB costs. The guidance should address issues similar to the provisions in CAS 413 to account for pension costs by segments. Although current FAR provisions cover many PRB issues, CAS 413 provides more detailed criteria for computing amounts to be adjusted after a segment closing. Specific problems pertaining to PRB costs should be addressed in new or revised cost accounting standards that deal with contractor accrued but unfunded past service liabilities.

When a contractor decides to change to accrual accounting, FAS 106 requires that the contractor recognize a liability pertaining to employee past service, the transition obligation. FAR 31.2-5-6(o) incorporates FAS 106 provisions for measuring PRB costs. Although FAS 106 permits the entire transition obligation to be charged in a single accounting period, FAR requires that the transition obligation be amortized using the delayed recognition method described in FAS 106. Another problem is that FAS 106 does not address cost allocation, and thus is not concerned with computing the Government's fair share of the transition obligation. Because computing the Government's fair share is important for contract costing, using the FAS 106 treatment of the transition obligation is not appropriate for Government contract accounting. To determine the Government's fair share of the transition obligation requires a comparison of accounting methods between accrual and pay-as-you-go for the entire period the contractor has been operating. Although such a computation would be accurate, it is not administratively feasible because it would require a reconstruction and reconfiguration of several decades' worth of past accounting records. The most reasonable alternative is to amortize the transition liability over future periods, which would spread the costs over a large number of contracts, thereby minimizing the impact on any particular contract or groups of contracts.

---

## Management Comment on Findings and Evaluation Response

**Director, Defense Procurement, Comment on Finding.** The Director, Defense Procurement, recommended that the last sentence on page 11, the second paragraph, "Funding is not required if the cash method is used," be deleted or rephrased. The Director, Defense Procurement, explained that the statement implies that funding could be required but that FAR has chosen not to include such a requirement. Further, when the cash method is used, the actual payment is a form of funding.

**Evaluation Response.** Although FAR 31.205-6(o)(3) requires that PRB costs assigned to the current year be funded or otherwise liquidated by the tax return time, the cash method is unlikely to be used in conjunction with funding. Specifically, FAR 31.205-6(o)(2), Cash basis, provides that costs recognized as benefits when they are actually provided must be paid to an insurer, provider, or other recipient for current year benefits or premiums. The wording excludes funding, hence, our statement. If a PRB fund exists, payments for current year benefits or premiums would presumably be made from that fund, and the allowability of costs paid from a fund is not an issue. Payments to the fund would not be for current year benefits or premiums but to provide for the portion of the actuarially determined liabilities assigned to the current period.

## Recommendation, Management Comment, and Evaluation Response

**B. We recommend that the Director, Defense Procurement, work with the Cost Accounting Standards Board to develop improved rules and regulations covering segment accounting for postretirement costs.**

**DDP Comments.** Concur. Over the past 5 years, we have worked with the CAS Board on this issue and we plan to continue this effort.

**Evaluation Response.** The comments are responsive to the recommendation. However, as we noted in the report, the CAS Board issued a discussion paper on "Cost Accounting Standard Relating to the Treatment of Costs of Post-Retirement Benefit Plans Other Than Pension Plans Sponsored by Government Contractors" in September 1996. Considering the problems that arise due to the inadequate regulatory coverage of specific PRB issues, we believe that the Director, Defense Procurement, should urge the CAS Board to accelerate the publication of a proposed rulemaking.

---

## Appendix A. Evaluation Process

### Scope

At the time of our review, a joint program for reviewing group insurance, including PRB costs, had not been implemented. In the absence of a joint review program, we developed our own program to test compliance with regulatory guidance. We also evaluated DCMA CIPRs and DCAA audits to find out what compliance tests were performed by each and to evaluate the adequacy of the tests of the joint work. In addition, we also reviewed several claims associated with PRB costs.

To evaluate the adequacy of DCMA CIPRs coverage of PRB costs, we reviewed the I/P specialists' tests of compliance with FAR 31.205-6(o) allowability criteria in 25 reviews performed at 23 contractors. When PRB costs were accounted for on a cash basis, we evaluated DCMA compliance tests used to determine whether the group insurance and associated PRB costs were reasonable. When accrual accounting was used, we looked to determine whether CIPRs cited contractors using non-FAS 106 actuarial methods for noncompliance with FAR 31.205-6(o)(2)(iii). When noncompliant actuarial methods were used, we reviewed whether the I/P specialists compared the PRB costs claimed using noncompliant methods to the FAS 106 allowability limits as required by FAR 31.205-6(o). We also tested to determine whether CIPRs evaluated the impact of funding practices and the associated reasonableness of cost allocations per FAR 31.205-6(o).

To evaluate the adequacy of DCAA audits of PRB costs, we reviewed the auditors' tests of compliance with FAR 31.205-6(o) allowability criteria in 22 audits. When audits addressed PRB costs that were computed using accrual accounting, we looked to determine whether auditors cited contractors that used noncompliant actuarial methods. When noncompliant actuarial methods were used, we determined whether the claimed PRB costs were compared to the PRB costs that were computed using the FAS 106 allowability limits, FAR 31.205-6(o). We also reviewed auditor tests of contractor funding practices for PRBs to ensure compliance with FAR 31.205-6(o) guidance. We evaluated DCAA coverage of contractors' methods for allocating PRB costs for compliance with CAS. In addition, we tested auditors' compliance with Generally Accepted Auditing Standards for evaluating the risk of internal controls over claims processing (Statement on Auditing Standards No. 70).

**Limitation to Scope.** We did not review DCAA and DCMA management control programs except to ask DCMA management what measures it took to improve quality of CIPRs as a result of our evaluations. Insufficient time had lapsed to evaluate significant recommendations agreed to in Inspector General, DoD, Report No. PO 97-013, "DoD Oversight of Defense Contractor Insurance and Pension Plans," March 28, 1997. DoD did not implement a recommendation to expand DCAA responsibilities in joint CIPRs for compliance testing until July 29, 1998. Also, a joint review program for pensions was only recently implemented.

---

The recommended joint review program for insurance has not been implemented. As a result of the significant changes recommended, we did not evaluate the management control program at this time.

## Methodology

**Use of Computer-Processed Data.** No computer-processed data were used in the course of the audit.

**Universe and Sample.** At the 3 DCMA field offices, we judgmentally selected 25 of the most recently issued reports for 23 of the largest contractors, as determined by sales dollars reported in the DoD Washington Headquarters Services publication, "100 Companies Receiving the Largest Dollar Value of Prime Contract Awards in 1996." In addition, we requested information from DCMA and DCAA on 12 recently settled or currently outstanding major contractor claims.

Because of the lack of a joint program for conducting reviews of PRB costs, we had to expand our coverage to evaluate oversight of PRB costs. Based on DCAA provided information on PRB costs and contractor accounting methods of 13 major contractors, we judgmentally selected 4 contractors for evaluation of audit work. Three of the four contractors represented were among the six largest in the universe and accounted for PRB costs using both cash and accrual accounting methods. The fourth contractor claimed high PRB costs and used only the accrual method. CIPR work had also been performed at the four contractors selected. At each contractor, we judgmentally selected DCAA completed incurred cost audit assignments in which DCAA had audited PRB costs, at least one forward pricing rate review that included estimated PRB costs, and audit reports on noncompliances with CAS 403 and 416. The DCAA audits were completed during the period from October 1, 1995, through December 31, 1998.

**Use of Technical Assistance.** The Audit Followup and Technical Support Directorate, Office of the Assistant Inspector General for Auditing, DoD, provided assistance in the review of the CIPR reports and agency guidance covered in the evaluation.

**Evaluation Type, Dates, and Standards.** We performed this economy and efficiency evaluation from February 1998 through December 1999 according to auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD.

**Contacts During the Evaluation.** We visited or contacted individuals and organizations within the DoD and within the Department of Health and Human Services, the Cost Accounting Standards Board, and the American Institute of Certified Public Accountants. Further details are available on request.

---

## **Prior Coverage**

During the last 5 years, the Inspector General, DoD, has issued three evaluation reports discussing the settlements of pensions and related issues.

Inspector General, DoD, Report No. PO 97-019, "Allegations of Inappropriate Action on Contracting Issues by Government Officials – Hughes Danbury Optical Systems," May 20, 1997.

Inspector General, DoD, Report No. PO 97-013, "DoD Oversight of Defense Contractor Insurance and Pension Plans," March 28, 1997.

Inspector General, DoD, Report No. PO 96-012, "DoD Oversight of Defense Contractor Business Combinations," June 28, 1996.



## Appendix B. Defense Contract Management Agency CIPRs Evaluated

Item No.	Contractor Name	DCMA Report No.	PRB Cost Reasonableness Not fully addressed	Compliance with FAR 31.205-6(o) Not fully addressed
1	Lockheed Martin	771198F91111001		X
2	Northrop Grumman	993396F11111010	X	X
3	Raytheon (1993-94)	771194F11111020		
4	Raytheon (1995-96)	771197S11111031		
5	TRW	771197S11111009	X	X
6	TRW	771197S11111026		X
7	Texas Instruments	992297F11111012	X	X
8	E-Systems	992297F11111006	X	X
9	ESCO	992296F11111012	X	
10	Aerospace	993394E11110011	X	
11	Allison Engine	771196S11111030	X	
12	Vought	882296F11111001	X	
13	Rockwell	993395F11111005	X	
14	GEC Marconi	771197F91111022	X	
15	Booz-Allen	771197F91111024		
16	Ceridian	992298F11111005		
17	Boeing	93-0004	X	
18	Sundstrand	992297F11111010	X	X
19	Alliant Techsystems	992295F11111023		X
20	Harris	771198F91111002		X
21	Litton	993395F11111006	X	
22	McDonnell Douglas	992298F11111002		
23	Hughes	993396F11111008		X
24	Battelle	771194F11111019	X	
25	United Technologies	771196F11111009		X

## Appendix C. Defense Contract Audit Agency Audits Evaluated

Item No.	Contractor and DCAA Assignment No.
	<b>Lockheed Martin:</b>
1	6631-97L10160404(I/C)
2	6631-97J10160410M(I/C)
3	6631-97J10160420(I/C)
4	6631-97C23000402(F/P)
5	6631-95J19200402(CAS)
6	6631-96C23000401(F/P)
7	6631-96C19416404(CAS)
8	6631-93J19416001(CAS)
9	4341-92F19200001(CAS)
	<b>Northrop Grumman:</b>
10	4721-98F10160002(I/C)
11	4721-96F14410001(I/C)
12	4721-96F19200001(CAS)
13	4721-9623000008(F/P)
14	4721-98F23000002(F/P)
	<b>Raytheon:</b>
15	2671-96A14410001(I/C)
16	2671-98A10160019(I/C)
17	2671-95A23000002(F/P)
18	2671-97A23000003(F/P)
	<b>TRW:</b>
19	1701-96D10160028(I/C)
20	1701-97014410002(I/C)
21	1701-98D23000001(F/P)
22	1701-97D23000005(F/P)

CAS - CAS compliance testing or reporting  
 F/P - Forward Pricing  
 I/C - Incurred Cost Audit

---

## **Appendix D. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
    Director, Defense Procurement  
    Director, Defense Logistics Studies Information Exchange  
Under Secretary of Defense (Comptroller)

### **Defense Organizations**

Director, Defense Contract Audit Agency  
Director, Defense Contract Management Agency  
Director, Defense Logistics Agency

### **Non-Defense Federal Organizations and Individuals**

Office of Management and Budget  
Technical Information Center, National Security and International Affairs Division,  
    General Accounting Office

### **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Governmental Reform  
House Subcommittee on Government Management, Information, and Technology,  
    Committee on Government Reform  
House Subcommittee on National Security, Veterans Affairs, and International Relations,  
    Committee on Government Reform



# Director, Defense Procurement Comments



ACQUISITION AND  
TECHNOLOGY  
DP/CPF

## OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON  
WASHINGTON DC 20301-3000

May 17, 2000

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL (AUDITING)

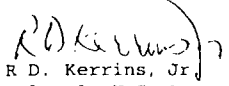
SUBJECT: Evaluation Report on Contractor Accounting and  
Estimating for Postretirement Benefit Costs and  
Related DoD Oversight (Project No D1998OA-0034)

I appreciate the opportunity to provide comments on the subject DoDIG audit report. The report recommends that my office work with the Cost Accounting Standards (CAS) Board to develop improved rules and regulations covering segment accounting for postretirement benefit costs.

Over the past five years, we have worked with the CAS Board on this issue, both through the public comment process and through working with the DOD member of the CAS Board, the Director of the Defense Contract Audit Agency. We plan to continue this effort, and therefore concur with your recommendation.

We have also identified, in the accompanying attachment, two factual inaccuracies contained in the subject report that we believe require correction.

Questions concerning this memorandum should be directed to Mr. David Capitano at 703 695 9764.

  
R. D. Kerrins, Jr.  
Colonel, U S Army  
Acting Director, Defense  
Procurement

Attachment:  
As stated

APPROVED

  
DIR (ARA)

5/24/00  
DATE



**Evaluation Report on Contractor Accounting and Estimating for  
Postretirement Benefit Costs and Related DoD Oversight  
Factual Inaccuracies**

**1 Page 4, Last paragraph:**

The report states "The purpose of CAS compliance testing is to ensure that contractors appropriately measure PRB costs, assign the costs to the accounting period, and allocate the costs to cost contracts equally "

Since the purpose of CAS allocation is to provide for an equitable allocation of costs among all contracts, we recommend the phrase "allocate the costs to cost contracts equally" be replaced with "provide for an equitable allocation of costs to contracts "

**2 Page 10, Second paragraph, last sentence:**

The report states "Funding is not required if the cash method is used " As worded, this statement implies that funding could be required, but that the FAR has chosen not to include such a requirement.

When the cash method is used, the actual payment is a form of funding Thus, we recommend this sentence be deleted If the sentence is retained, we recommend it be reworded to state "When the cash method is used, funding is accomplished by the cash payment itself."

Revised

page 11

ATTACHMENT

# Director, Defense Contract Audit Agency Comments

Final Report  
Reference



DEFENSE CONTRACT AUDIT AGENCY  
DEPARTMENT OF DEFENSE  
8725 JOHN J. KINGMAN ROAD, SUITE 2135  
FORT BEL VOIR, VA 22060-6219

IN REPLY REFER TO

20 June 2000

PAC 225/98-2

MEMORANDUM FOR DEPUTY ASSISTANT INSPECTION GENERAL FOR AUDIT  
POLICY AND OVERSIGHT, DOD INSPECTOR GENERAL

SUBJECT: Response to the Draft Evaluation Report on Contractor Accounting and Estimating  
for Postretirement Benefit (PRB) Costs and Related DoD Oversight  
(Project No. D19980A-0034)

In response to your request for comment on the subject draft evaluation report, we are  
providing the following comments:

- 1 Page 9 of the draft evaluation report makes the following recommendation:

We recommend that the Director, Defense Contract Management Agency, coordinate with the Director, Defense Contract Audit Agency to complete a joint review guide for group insurance costs, including postretirement benefit costs, within 60 days from the date of this report. Review steps should be included to test compliance with regulations, including the allocation of group insurance costs and to obtain information on service organizations.

DCAA Comment: While this recommendation is not directed to DCAA, we will work with DCMA to complete a joint review program for group insurance costs, including PRB costs.

- 2 Page 7 of the draft evaluation report notes the following deficiency:

Two incurred cost audits at Raytheon and two at Northrop Grumman Corporation did not adequately document an analysis of the contractor's use of an actuarial cost method not acceptable per FAS 106.

DCAA Comment: At Raytheon, the Defense Corporate Executive (DCE) approved the contractor's insurance/pension system based on the advice of the Defense Contract Management Agency (DCMA) insurance/pension specialist who evaluated and accepted the contractor's actuarial cost method. After the DCE's approval of the system, the two incurred cost audit reports were issued. Given these circumstances, we will coordinate the IG concern with DCMA.

page 10

page 6

PAC 225/98-2

SUBJECT: Response to the Draft Evaluation Report on Contractor Accounting and Estimating  
for Postretirement Benefit (PRB) Costs and Related DoD Oversight  
(Project No D19980A-0034)

to ensure that the contractor's actuarial cost method is proper. We will also coordinate with  
DCMA concerning Northrop Grumman Corporation's actuarial cost method.

3 Page 7 of the draft evaluation report notes the following two interrelated deficiencies  
concerning contractor funding of PRB costs:

Two incurred cost audits at TRW did not identify  
potential increased costs due to contractor delayed  
funding of PRB costs. We estimated the lost interest  
caused by delayed funding to be about \$395 thousand  
in 1996. The practice of delayed funding had existed  
for several years and was not discontinued until 1998.  
We projected that over a 3-year period the lost interest  
may have been \$1.2 million.

Two forward pricing audit reports issued by the TRW  
corporate audit office did not disseminate information  
to segments on the need to exclude any unfunded PRB  
expenses from progress billings.

DCAA Comment: We will question increased costs caused by delayed funding of PRB  
costs for overhead years for which the ACO has not settled the overhead rates. As your report  
notes, TRW began quarterly funding of PRB costs in 1998. As a result, no PRB costs need to be  
excluded from current progress payments.

If you have any questions, please contact Mr. Gerry Reichel, Program Manager,  
Accounting and Cost Principles Division, at (703) 767-3250, or e-mail at  
DCAA-PAC@dcaa.mil



Lawrence P. Uhlfelder  
Assistant Director  
Policy and Plans

page 6 and 7



# Director, Defense Contract Management Agency Comments

Final Report  
Reference



DEFENSE CONTRACT MANAGEMENT AGENCY  
8725 JOHN J. KINGMAN ROAD, SUITE 4539  
FORT BELVOIR VIRGINIA 22060-6221

IN REPLY  
REFER TO DCMA-OCB

JUN 23 2000

MEMORANDUM FOR ASSISTANT INSPECTOR GENERAL, POLICY AND OVERSIGHT,  
DEPARTMENT OF DEFENSE

SUBJECT: Response to DoD IG Draft Report on Evaluation of Contractor Accounting and  
Estimating for Post Retirement Benefit Cost and Related DoD oversight (Project No  
D1998OA-0034)(Formerly 80C-9011)

The following information is provided in response to the subject draft report issued April  
21, 2000. We appreciate the opportunity to comment.

Although the title of your report refers to "post retirement benefit cost," the findings and  
recommendations refer to group insurance. We recommend that the title of your report be  
changed to include the words "Group Insurance, Including Post Retirement Benefits." Also,  
under Executive Summary, you state that health care benefits constitute about 80 percent of post  
retirement benefit expenditures. We recommend the report clarify that the term "post retirement  
benefit expenditures" means those expenditures excluding pension benefits.

**FINDING:** DoD oversight of contractor post retirement benefits (PRBs) other than  
pensions need improvement in some areas. The lack of adequate oversight occurred because  
DCMC managers did not provide adequate guidance and appropriate industry norms for  
determining reasonableness. In addition, reviewers did not consistently test and document  
whether costs were allowable as required by regulatory guidance, and the reviewers did not  
address contractor use of service organizations. Also, DCMC managers did not formalize  
individual review steps for conducting group insurance reviews. The deficiencies in review  
coverage could result in overpayments to DoD contractors for group insurance costs that are not  
allowable, allocable, or reasonable. For example, for 2 of the 23 contractors reviewed, we  
estimated that the impact could have been \$4.7 million.

**DCMA COMMENTS:** Nonconcur. Much of the guidance in this arena is found in  
CAS 416 and FAR 31.205-6(o). Although specific review steps have not been formalized, the  
CIPR Teams methodically use these regulations as their guide in reviewing the contractors' PRB  
programs. Also, the CIPR Teams use employee benefit surveys of large corporations such as  
those prepared by Blue Cross/Blue Shield and Buck Consultants as a baseline for reasonableness.

Revised

RECOMMENDATION A.1: We recommend that the Director, Defense Contract Management Agency, issue guidance for using the actuarial survey to evaluate group insurance that addresses when costs should be questioned as unreasonable

DCMA COMMENTS: Concur Although the CIPR Teams are already doing so, DCMA will reinforce the use of actuarial surveys to evaluate contractors' group insurance programs by issuing a policy change notice


DISPOSITION: Action is ongoing ECD: September 30, 2000

RECOMMENDATION A.2: We recommend that the Director, Defense Contract Management Agency, coordinate with the Director, Defense Contract Audit Agency to complete a joint review guide for group insurance costs, including post retirement benefit costs, within 60 days from the date of this report Review steps should be included to test compliance with regulations, including the allocation of group insurance costs and to obtain information on service organizations

DLA COMMENTS: Concur In coordination with DCAA, DCMA will formalize a guide for reviewing contractors' group insurance programs, including post retirement benefit costs, with emphasis on ensuring adequate supporting documentation is readily available

DISPOSITION: Action is ongoing ECD: September 30, 2000

If you have any questions, please contact Patrick Ring of my staff at 703-767-3385

  
TIMOTHY P. MALISHENKO  
Major General, USAF  
Director

## **Evaluation Team Members**

This report was prepared by the Deputy Assistant Inspector General for Audit Policy and Oversight, Office of the Assistant Inspector General for Auditing, DoD.

Patricia A. Brannin  
Wayne C. Berry  
Madelaine E. Fusfield  
Ronald R. Meissner